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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

June 30, 1994

VIA HAND DELIVERY

Mr. William Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Ex parte Presentation
(RM 8355)

Dear Mr. Caton:

Today, Hector Lugo, Encarnita Catalán, and I had four ex parte presentations in the above-captioned proceeding. I am attaching two copies of the presentation we shared at these meetings.

In our first meeting, we met with Richard Metzger, Kelly Cameron, Diane Cornell, George Li, and Troy Tanner of the Common Carrier Bureau.

In our second meeting, we met with Commissioner Quello and Lauren J. Belvin.

In our third meeting, we met with James Coultharp in Commissioner Barrett's office.

In our fourth meeting, we met with Chairman Hundt and Karen Brinkman.

Respectfully submitted,

Alfred M. Mamlet

Alfred M. Mamlet
Counsel for Telefónica Larga
Distancia de Puerto Rico, Inc.

/srh-m

Enclosure

cc: See attached list

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List ABCDE

cc list:

Richard Metzger	Commissioner Quello
Kelly Cameron	Lauren J. Belvin
Diane Cornell	James Coultharp
George Li	Chairman Hundt
Troy Tanner	Karen Brinkman

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JUN 30 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

ECONOMIC BENEFITS TO PUERTO RICO FROM VIGOROUS TELECOMMUNICATIONS COMPETITION

June 27, 1994

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Glassman-Oliver Economic
Consultants, Inc.
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Washington, D.C. 20036

EXECUTIVE SUMMARY

Prior to 1989, AT&T and its predecessor enjoyed a monopoly in off-island telecommunication services for Puerto Rico. However, the anticipation of and then the reality of entry by Telefonica Larga Distancia, Inc. (TLD) together with the advent of equal access led to significant declines in off-island rates. For example, Band 1 daytime rates fell 41 percent between 1986 and 1993. Today, TLD's Band 1 tariff is $0.20 per minute compared with AT&T's price of $0.27 per minute for the same service.

We estimate that the total savings to Puerto Rican consumers from post equal access competition in off-island service is at least $578 million. Since TLD is AT&T's major competitor, most of these consumer savings are attributable to TLD's entry.

By 1992, TLD had achieved a 21.6 percent market share in minutes of international calling originating in Puerto Rico, while AT&T's share had fallen to 59.9 percent. Although Sprint and MCI also serve this market, with shares of 7 percent and 6.5 percent respectively, they have not shown themselves to be nearly the competitive challenge that TLD has been to AT&T. Moreover, TLD's impressive achievement in market presence understates its important role as the only carrier with a continuing interest in serving the low volume residential and small business customer.

TLD has also been an aggressive competitor to AT&T on international routes. For example, the Dominican Republic is the most popular destination for international calls originating from Puerto Rico. After TLD's entry AT&T dropped its Band 1 daytime tariff for calls to the Dominican Republic from $0.75 per minute to $0.66 per minute but TLD's rates are even lower at $0.63 per minute.

There is no question that future Puerto Rican economic development would be bolstered by a highly competitive market for off-island telecommunications services. We estimate that a drop in tariffs by about 17 percent, such as the reduction recently made by TLD in its Band 1 daytime rate to $0.20, if adopted by all competitors would generate an increase in Puerto Rican GDP of between $19 million and $31 million. This economic boost would create between 801 and 1325 new jobs for Puerto Rico.

When a dominant firm is under competitive pressure primarily from a single rival, the strength of competition depends in large part on the strength of that rival. Regulatory actions that restrict AT&T's primary Puerto Rican rival pose serious potential threats to the health of competition for off-island services originating in Puerto Rico. FCC regulatory actions have a major effect on telecommunications competition. We have all witnessed the pro-competitive effects that deregulation in telecommunications has brought to the U.S. and to the international market place.

However, regulatory actions can also have unintended and harmful consequences for competition. For example, prohibiting TLD from participating in the AMERICAS-1 and COLUMBUS II cable systems would have seriously detrimental effects on competition because it would handicap the carrier that has been the primary competitive constraint on AT&T. We estimate that the new cable systems will provide a cost savings of about one cent per minute (about 4.4%) to TLD. The savings may even be greater for AT&T. However, the magnitude of TLD's cost savings would not be passed on to consumers by AT&T in the off-island market if TLD will not be able to place additional competitive pressure on its principal rival. Granting TLD's cable systems applications would ensure that Puerto Rican consumers will benefit from the cost reductions provided by these new cable systems. These cost reductions would amount to a $6 million annual savings for Puerto Rican customers.

The immediate regulatory concern over TLD's participation in AMERICAS-1 and COLUMBUS II has been linked to the opening up of foreign markets to U.S. carriers and to the "high" levels of foreign settlement rates. This linkage is unfounded and should prove to be costly to the Puerto Rican economy. Illusive trade policy objectives provide a bad bargain for Puerto Rican business and residential customers if they sacrifice current sizeable competitive benefits for only a potential pressure to open a foreign market to American business entry. While opportunistic protectionist rhetoric from AT&T may be colorful, the true immediate gain to AT&T if its petition is granted is that it will face significantly diminished competition in Puerto Rico.

Deregulation has worked in Puerto Rico. The benefits that derive from long-distance competition, including lower prices and higher quality services for consumers, lower costs and increased efficiency for businesses, and economic growth and employment expansion for the economy as a whole, depend on the ability of TLD to continue to act as a strong competitor to AT&T.

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THE ECONOMIC BENEFITS TO PUERTO RICO FROM VIGOROUS TELECOMMUNICATIONS COMPETITION

I. INTRODUCTION

Telefónica Larga Distancia Inc. (TLD) has asked Glassman-Oliver Economic Consultants Inc. to examine the benefits to the Puerto Rican economy from vigorous competition in the market for off-island telecommunications. The benefits from competition may be threatened when regulatory restrictions prevent an important telecommunications provider from competing on a level playing field. This threat is the reason we have also been asked to evaluate the efficacy of such regulatory restrictions and what it would mean for the Puerto Rican economy.

Vigorous competition in this market is relatively new. Indeed, not until the entry of TLD and the advent of equal access in 1989 were Puerto Ricans able to realize the benefits that market competition bestows. Competitive pricing, a greater variety of product and service offerings, efficiency enhancing services (and with them productivity and employment growth) are typical of the benefits to Puerto Rican residential and commercial customers that result from vigorous competition in telecommunications.

These competitive gains have not and do not come easily. While competition clearly benefits customers and more broadly the economy, it is not always kind to all competitors. Incumbent firms with what would otherwise be entrenched market power see the entry of new firms as threatening to the status quo as measured in price levels, market shares and product offerings. These threats to existing and or anticipated monopoly rents explain the opposition that new entrants and aggressive competitors are often subjected to in the marketplace, the courts and the regulatory agencies.

The strength of competition and the resulting breadth of benefits provided to Puerto Rico are dependent on the regulatory environment in which long distance carriers compete. The limited history of market competition in Puerto Rico is also an indication of its fragility. If the costs of competing may easily be raised by manipulation of the regulatory process, whenever a threatened rival perceives that competition is to become more intense or that its market advantages are to be attenuated, the long term survival of vigorous competition is at stake.

In the analysis that follows, we examine the significant contribution that TLD has made to the development of vigorous competition in the off-island telecommunications market and its prospects for continuing as AT&T's main rival in Puerto Rico. We also analyze the significance of the regulatory environment to maintaining TLD in this important role and measure the consequences for competition and Puerto Rico should TLD face regulatory restrictions on its ability to compete.

We find that a regulatory environment that avoids raising one firm's costs relative to its rivals helps to maintain competition and constrain the exercise of market power. As the Information Superhighway develops, open telecommunications competition is especially critical. Moreover, we find that the most effective means of placing pressure on foreign markets to open up for U.S. carriers is likely to be market forces finding alternative distribution mechanisms that subvert barriers to entry and high prices and not regulations that control access to U.S. technology and the U.S. market.

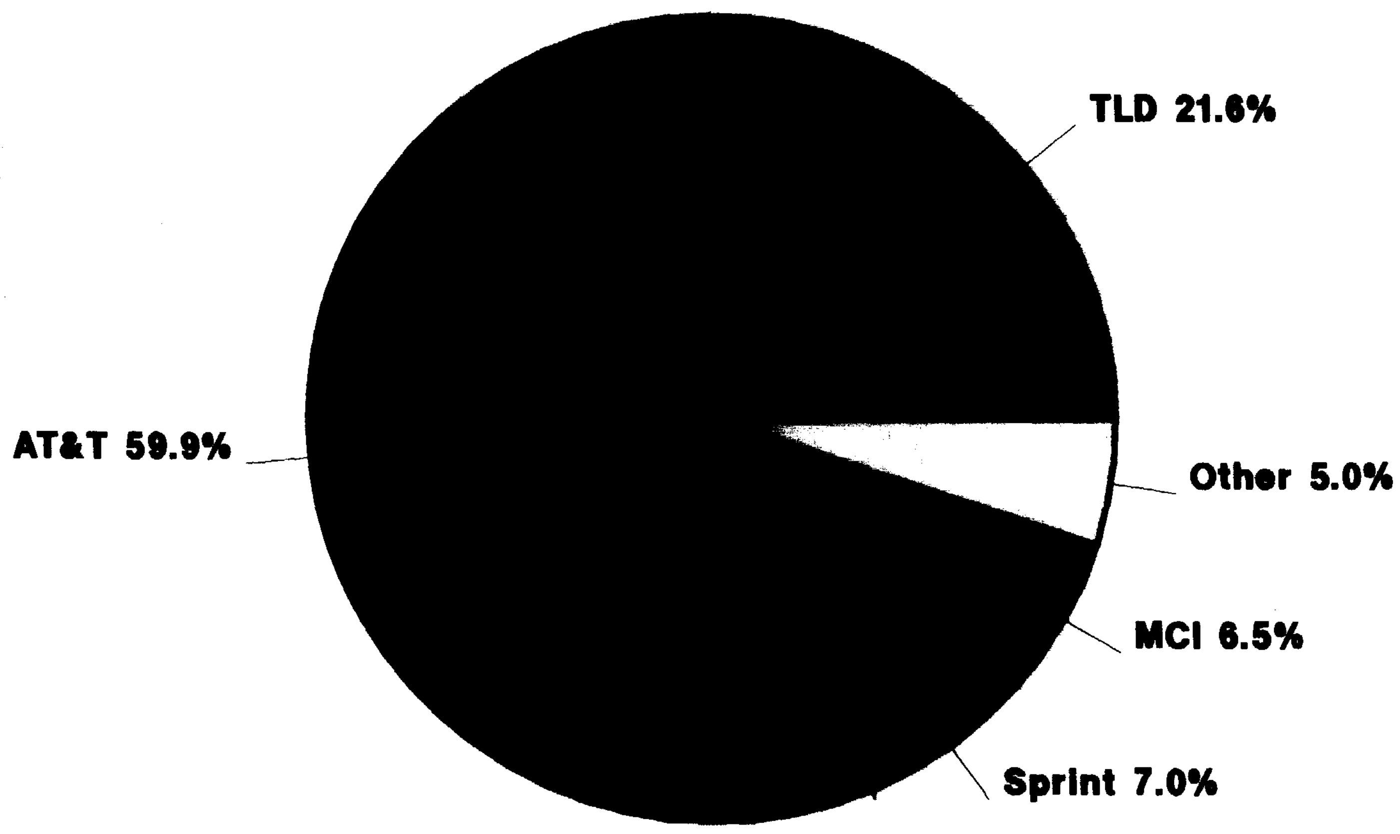
II. THE COMPETITIVE IMPORTANCE OF TLD RELATIVE TO ITS RIVALS

A. Market Concentration

Only four carriers offer long-distance services that are available to the vast majority of Puerto Rico's 1.1 million access lines. AT&T and TLD serve over 80 percent of the market for off-island services and should, therefore, be considered the only two major competitors.[1/] **Figure 1** presents market shares based on 1992 international message telephone service originating in Puerto Rico. Measured in minutes, AT&T has 59.9 percent of the market and TLD

[1/] The calculation of market shares presumes that a "relevant market" has been defined. Competition analysts generally define a market to be the narrowest group of products or services for which a hypothetical monopolist could profitably impose a 5 percent price increase. See "Department of Justice and Federal Trade Commission Horizontal Merger Guidelines," April 2, 1992, Section 1.1. In other words, the relevant market must be broad enough so that very few customers would substitute to services outside of that market if prices were to rise. Using this methodology Puerto Rican off-island telecommunications services appears to be the relevant market. Although potential substitutes such as overnight mail service are available, it appears unlikely that many customers would substitute away from telecommunications toward such services to a substantial degree in response to a 5 per cent price increase for off-island telephone services.

FIGURE 1
MARKET SHARES
PUERTO RICO INTERNATIONAL TELEPHONE SERVICE
(MINUTES)



Source: Section 43.61 Reports for 1992

has 21.6 percent, while Sprint and MCI have 8.5 percent and 8.8 percent, respectively.[2] Two other firms service a select few business accounts, but do not offer services to households or most business customers. These figures clearly indicate that AT&T is the dominant firm in this market, and that TLD is the principal threat to AT&T's entrenched market position.[3] This conclusion also is supported when market shares are measured in message units or billed revenues.

When market shares are measured in terms of access lines, TLD has a much larger share, 44%. The divergence between TLD's share when measured in terms of traffic and access lines is due to the fact that TLD services a very high proportion of low-volume customers.[4] In any event, by any measure the combined shares of

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[2] The market shares are somewhat different if based on messages, billed revenue, or access lines.

	Int'l Messages	**Int'l Revenue**	**Access Lines**
AT&T	57.2%	66.5%	39%
TLD	22.7%	17.2%	44%
Sprint	7.6%	6.2%	7%
MCI	7.8%	6.7%	5%
Other	4.7%	3.4%	5%

Source(s): 1992 43.61 reports and TLD "Plan Quinquenal," 1994.

[3] Data is not available to calculate domestic market shares, but it appears that international shares are a good proxy for all off-island shares.

[4] When market concentration figures are used to illustrate market power, they generally are calculated based on dollar sales or unit sales, not the number of customers. See "Department of Justice and
(continued...)

AT&T and TLD are 80 percent or more, indicating that these are the primary suppliers to the off-island market.

B. Telefónica Larga Distancia, Inc.

TLD was authorized to compete by the FCC in 1988,[5] and initiated service in 1989. This culminated a decade long effort by TLD and its predecessor in the face of fierce opposition by AT&T and its predecessor to enter the off-island market.[6] As AT&T feared, TLD immediately made its presence known as an aggressive competitor through an active and successful campaign to sign up new customers during the equal access period. Starting from ground zero, TLD has battled AT&T to achieve a substantial share of the market. Neither MCI nor Sprint have been able to achieve half the market share of TLD. TLD has invested over $45 million in technology and infrastructure since it was established in 1989. Since then, it has grown to 328 employees with revenues of about $70 million per year.

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[4](...continued)
Federal Trade Commission Horizontal Merger Guidelines," April 2, 1992 (Section 1.4). Therefore, calculating market shares based on minutes of traffic (or dollars of revenue) is the preferred approach.

[5] In re La Telefónica Larga Distancia de Puerto Rico, 3 FCC Rcd. 5937 (1988).

[6] See, e.g., In re Puerto Rico Telephone Co., 92 F.C.C. 2d 1444 (1983), rev'd, All American Cables and Radio, Inc. v. FCC, 736 F.2d 752 (D.C. Cir. 1984); In re Inquiry into Policies to be Followed in the Telecommunications Authorization of Common Carrier Facilities to Provide Telecommunications Service Off the Island of Puerto Rico, 2 FCC Rcd. 6600 (1987).

TLD has been a major force in bringing competition to the Puerto Rican long-distance telephone market. Due in large part to its entry in 1989, the prices of long-distance services have dropped significantly.[7] Both actual and potential competition from TLD has resulted in substantial savings to residential, business, and government customers that might not have occurred in its absence. In addition, since TLD's entry, the services supplied by long-distance carriers in Puerto Rico have expanded dramatically. Much of this expansion is attributable to the new market conditions created by TLD's competitive entry and equal access.

TLD's unique attention to servicing small business and residential customers is an important element of its competitive role in Puerto Rico. Profiles of TLD's customers from a recent customer sample survey it conducted are presented in **Table 1** and **Table 2**. These figures show that TLD's customer base is 71 percent residential. TLD's business customers are predominantly small local businesses (with 50 or fewer employees) focused heavily in the service sector and service-related areas such as wholesale distribution and the retail trade.

TLD services small business and residential customers in spite of their low profitability. For example, large numbers of residential customers selected TLD during the equal access period

[7] Price competition will be discussed in greater detail in Section III below.

TABLE 1

TLD CUSTOMER PROFILES

TLD PRESUBSCRIBED LINES	
Business	16%
Residential	71%
Government	10%
Payphones	3%

TLD ORIGINATED TRAFFIC	
Residential	66%
Business	30%
Government	4%

TLD BUSINESS ESTABLISHMENT PROFILE	
Small	70%
Large	30%

TLD BUSINESS ESTABLISHMENT ORIGIN	
Local	61%
Multinational	39%

TABLE 2

TLD BUSINESS CUSTOMER PROFILES

TLD MARKET SECTOR	
Manufacturing	26%
Distribution	23%
Service	22%
Retail	9%
Communications & Transportation	9%
Construction	6%
Finance, Insur. & Real Estate	5%

KIND OF BUSINESS	TLD BUSINESS ESTABLISHMENT PROFILE			
	SMALL	LARGE	LOCAL	MULT.
Manufacturing	42%	58%	38%	62%
Distribution	74%	26%	68%	32%
Service	77%	23%	75%	25%
Retail	92%	8%	85%	15%
Comm & Transportation	67%	33%	48%	52%
Construction	79%	21%	86%	14%
Fin., Insur. & Real Estate	37%	63%	44%	56%

but do not use a significant quantity of long-distance services. It is costly for TLD to maintain these relatively inactive customer accounts.[8] Nevertheless, favoring a long-term view, TLD continues to offer these customers direct access to long distance services if and when they demand them. This market segment has developmental potential and has been largely disregarded by TLD's competitors.

Currently, 94.1 percent of U.S. households have telephone service, compared to only 65.8 percent of Puerto Rican households. The opportunity for growth in telecommunications is obvious and TLD has played a major role in expanding Puerto Rican citizens' access to long-distance telecommunication services. TLD's service to low-volume users is reflected in the fact that TLD averages only $10.96 in monthly revenue per subscriber line compared to $29.23 for AT&T.[9] While customers throughout the island would suffer if TLD were not able to compete effectively, it is the low-volume residential and small business customers that would suffer most, because it is far from certain that they would receive competitively priced services absent the aggressive competitive presence of TLD.

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[8] TLD's costs of servicing these inactive accounts include both its direct servicing costs and its contribution to the Universal Service Fund. Because payments into the Universal Service Fund are based on its number of subscribers, TLD pays 1.15 cents per billed minute into this fund while AT&T pays 0.25 cents per minute. See TLD's "Reply Comments in Support of AT&T Petition for Rulemaking," January 31, 1994, at 2.

[9] Ibid., at 3. These figures are nationwide averages.

In 1993, TLD focused on increasing its traffic volume, particularly among business customers. Tariffs for daytime traffic were revised downward with this goal in mind. Reduced daytime tariffs should increase TLD's domestic and international sales to businesses substantially.

TLD currently offers a wide variety of telecommunication services and is in the process of introducing more. Private lines, 800 service, 900 service, calling-card services, specialized billing services and various discount programs are now available. TLD is planning to introduce videoconferencing, voice mail and packet switching service. These services will be closely competitive with those of AT&T. TLD plans to compete head-to-head with AT&T for major services, as well as new developments in services.

C. AT&T

Prior to 1987, All American Cable & Radio (AAC&R) had a monopoly on off-island service originating in Puerto Rico. In 1987, AT&T purchased this monopoly. Today AT&T is the market leader and TLD is the closest competitor. From Figure 1 we see that AT&T enjoys a 59.9 percent share of international minutes originating in Puerto Rico. AT&T offers a broad range of services to its residential and business customers.

Its tariffs are significantly higher than TLD's, particularly for the primary business rate, Band 1 Daytime, where AT&T currently charges $0.27 and TLD charges $0.20.[10]

As suggested earlier, head-to-head competition between these two carriers is the predominant component of both domestic and international telecommunications long distance competition in Puerto Rico. One demonstration of the close competition between AT&T and TLD is the focus of AT&T's advertising to the public. TLD is the only competitor that merits the attention of AT&T in its Puerto Rican advertisements. An industry's leading firm targeting its competitive efforts on a particular competitor when those two firms' market shares are as high as AT&T's and TLD's weighs heavily toward a presumption that the targeted firm is the primary force in the market, acting as a restraint on the leading firm's exercise of market power.[11]

Well before it battled TLD in the marketplace, AAC&R/AT&T acted to delay TLD's entry by a decade, effectively protecting its monopoly position and postponing the benefits from competition.[12]

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[10] Price competition will be discussed in greater detail in Section III.

[11] See "Department of Justice and Federal Trade Commission Horizontal Merger Guidelines," April 2, 1992, Section 2.211.

[12] See, e.g., In re La Telefónica Large Distancia de Puerto Rico, 3 FCC rcd. 5937 (1988), In re Puerto Rico Telephone Co., 92 F.C.C. 2d 1444 (1983), rev'd, All American Cables and Radio, Inc. v. FCC, 736 F.2d 752 (D.C. Cir. 1984); In re Inquiry into Policies to be Followed in the Telecommunications Authorization of Common Carrier Facilities to Provide Telecommunications Service Off the Island of Puerto Rico, 2 FCC Rcd. 6600 (1987).

AT&T has continued to oppose virtually every application TLD has filed since it entered the market. This tactic appears to be merely a continuation of its use of the regulatory process to attempt to weaken its major competitors in the marketplace, and to maintain market power.

D. MCI and Sprint

Both MCI and Sprint offer limited services, in large part because many services cannot be cost-justified with such a small share of a relatively small market. (See Figure 1.) For example, unlike TLD, MCI does not offer 24 hour customer service access in Puerto Rico. As a consequence, it cannot provide unlimited access to information about its services, billing, dialing instructions, etc. to customers, as does TLD. Moreover, MCI does not maintain its own Operator Center, but instead contracts with a local carrier for operator services. Particularly for collect calls, which are a major component of domestic and international traffic originated in Puerto Rico, efficient operator services such as those provided by TLD are an important component of adequately serving Puerto Rican customers.

Thus, MCI's services are substantially limited relative to TLD. MCI has only 60 employees in Puerto Rico, about one-fifth of TLD's work force, and Sprint has only 30. With these small work forces MCI and Sprint cannot offer the same range of services as AT&T and TLD.

Although it has a limited presence in Puerto Rico, MCI nevertheless profits from doing business with TLD. TLD routes about 90 percent of its domestic traffic through MCI switches in Miami and New York. Thus, independent of MCI's own Puerto Rican business, MCI gains substantial revenues from TLD's Puerto Rican domestic calling traffic. As TLD's domestic capacity increases, MCI's profits will also increase.

The significance of MCI's competitive role in Puerto Rico is reflected in its pricing. While competition has resulted in several price changes (mostly reductions) by TLD and its other competitors since 1989, MCI has only instituted one change in price (a small reduction in 1991), and has not reacted either to TLD's and Sprint's price cuts, nor for that matter to AT&T's price increases.[13/] Similarly, MCI's 800 service charges are significantly higher than TLD's. Somewhat in contrast, Sprint recently has been more aggressive in its pricing than MCI, but still has a very limited market share and presence in Puerto Rico.

III. PRICE COMPETITION AND CONSUMER BENEFITS

A. Domestic Price Competition

Section II illustrated how competition has shaped the Puerto Rican carriers' market shares. Section III will evaluate how this

13/ See Figure 4, infra.

competition has affected prices, and will highlight the consumer benefits from this competition.

The FCC's elimination of many regulatory barriers to competitive provision of long-distance services has resulted in great savings in Puerto Rico and throughout the U.S. One study estimates that a typical residential user has seen a reduction in average U.S. prices of long distance services of 45 percent since 1984.[14/] TLD's Band 1 daytime tariff is 54 percent lower than the 1984 tariff that Puerto Rican customers paid AT&T's predecessor, AAC&R.

When equal access was initiated in 1989, AT&T's Band 1 daytime rate was $0.27. Since equal access, TLD's price for Band 1 daytime service has averaged 23 cents while AT&T's has averaged 25 cents.[15/] **Figure 2** illustrates tariff rates both before and after equal access. We see that the Band 1 daytime tariff fell from $.41 in 1986 to $.27 in 1988. Then each competitor's rate hovered near $.25 (with TLD's rate generally the lowest) until 1992-1993, when Sprint and TLD lowered their rates and AT&T raised its rate.[16/]

AT&T presumably reduced its Band 1 daytime rates from $.41 in 1986 to $.27 in 1988, a reduction of 34%, in anticipation of

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[14/] U.S. Department of Commerce, The NTIA Infrastructure Report: Telecommunications in the Age of Information, October 1991, at 207.

[15/] Source: FCC tariff filings. These averages are weighted averages whereby each price charged is weighted by the length of time that price was in effect.

[16/] Figure 4, infra, provides a clearer resolution of the post-equal access pricing.

FIGURE 2
PUERTO RICO DOMESTIC TARIFFS 1986–1994
BAND I DAYTIME